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9<sup>th</sup> April 2010

Dear Hannah

### **Regulating energy networks for the future: RPI-X@20 Emerging Thinking**

The Wales & West Utilities (WWU) response to the RPI-X@20 - Emerging Thinking Main Consultation is set out below. In addition to this response, we have responded separately to the parallel consultation – Embedding financeability in a new regulatory framework

WWU is a licensed Gas Distribution Network (GDN) providing Gas Transportation services for all major shippers in the UK. We cover  $\frac{1}{6}$ <sup>th</sup> of the UK land mass and deliver to over 2.4 million supply points. WWU Limited is one of only two Licence Operators that focus solely on Gas Distribution in the UK.

WWU has been fully supportive of the Ofgem review of the Regulatory framework known as RPI-X@20. We have, and will continue to support the workshops and consultation processes as it is imperative that any conclusions implemented are workable and support the outcomes below.

### **Executive Summary**

It is quite clear that the current challenges facing the UK and UK energy are different to the challenges that existed twenty years ago when the RPI-X regime was introduced. The UK energy market structure, the application of the RPI-X regime, and Licence Obligations for the different participants have also evolved significantly over that time.

There are many current uncertainties in the UK and the UK energy sector. Whilst we have known legislation for our environmental challenges, there is clear uncertainty and ambiguity about how and when the UK will meet these challenges. This leads to an uncertain energy mix from 2020 to 2050. If you couple this uncertain future with the current economic climate and growing fuel poverty in the UK, it appears to suggest the need for a regulatory regime that is flexible and evolves to address the changing environment.

It is broadly recognised that the RPI-X@20 basis of network regulation has proven adaptable and has served the energy sector well. We believe the existing RPI-X regime with some enhancement can facilitate the outcomes we highlight below.

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\*calls will be recorded and may be monitored  
caiff galwadau eu recordio a gellir eu monitro

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Due to the complex structure, it is unlikely that a review of the network regulatory regime in isolation will address all of the issues that the energy sector faces. The networks provide limited services, governed by their Licence Obligations. We agree the network regulatory regime can help; but to facilitate many of outcomes outlined by the RPI-X emerging thinking many other tools will be required. These may include policy changes, a review of the Licence Obligations for all energy sector players and a possible review of the market structure. This is an important point as we do not think the success or failure of the RPI-X@20 project should be judged by reference to delivery of the current Energy sector challenges. The RPI-X@20 review for networks should be judged against the success criteria of “Regulatory improvement for networks”. Any move away from the existing framework should demonstrate better facilitation of the desired outcomes. The Regulation framework must ensure

- Efficient networks are able to finance their licence obligations;
- Networks are able to attract investment from competitive capital markets;
- An equitable sharing of risk between networks and consumers;
- Networks should not be subject to risks they cannot control;
- Networks are accountable to end consumers;
- Networks are incentivised to provide services that stakeholders value;
- Networks that demonstrate excellence are rewarded appropriately;
- Adaptability in a changing environment

Whilst we are generally supportive of the framework proposed by Ofgem, we have a concern that some of the detail contained within the emerging thinking will not better facilitate the desired outcomes or deliver the challenges that are being highlighted by Ofgem’s other major project - project discovery. Most of our concern is linked to the practical implementation of many of the Embedded Financeability straw man principles. If not implemented correctly, they could introduce significant risk and uncertainty for investors and put future security of supply at risk through lack of investment.

In summary; and in principle, we support many of the themes of the review: EG: continuation of an “Ex Ante” RPI-X framework with a greater emphasis on outputs, richer business plans and greater stakeholder engagement. However, when we drill down into the detail of some of the Ofgem emerging thinking we have concerns that some of detail proposed will inhibit investment, increase uncertainty and reduce flexibility.

There are several references to further Emerging Thinking documents and we hope any additional material is shared as soon as possible. The lack of relevant content would be a barrier to allowing the industry to comment fully on the emerging thinking. This is particularly relevant to the Embedded financeability Emerging Thinking.



We provide our detail responses to the main consultation as Appendix 1 and provide our response to the Embedded Financeability consultation as a separate document.

Yours sincerely

A handwritten signature in black ink, appearing to read "S. Edwards", with a long horizontal flourish extending to the right.

Steve Edwards  
Head of Commercial and Regulation  
Wales & West Utilities

## **Appendix 1 : WWU Response to the Main Consultation Questions**

### **Chapter 1**

**Question 1:** Do you think our desired outcomes for the future regulatory framework are appropriate? Are there any we have missed?

We think the desired outcomes, as defined by Ofgem in Paragraph 1.7 and 1.8 fall short of those required to ensure appropriate regulation of energy networks. Ofgem list two desired outcomes; Sustainability and Value for money for end consumers. Whatever the future regulatory framework, we think the desired outcomes should ensure:

- Efficient networks are able to finance their licence obligations;
- Networks are able to attract investment from competitive capital markets;
- An equitable sharing of risk between networks and consumers;
- Networks should not be subject to risks they cannot control;
- Networks are accountable to end consumers;
- Networks are incentivised to provide services that stakeholders value;
- Networks that demonstrate excellence are rewarded appropriately;
- Adaptability in a changing environment

**Question 2:** Do you agree that we need a fundamental change to the existing 'RPI-X' frameworks to ensure these outcomes are delivered?

Due to the complex UK energy structure, it is unlikely that a review of the network regulatory regime in isolation will address all of the issues that the energy sector, as a whole, faces. The networks provide limited services, governed by their Licence Obligations. We agree the network regulatory regime can help; but to facilitate many of outcomes outlined by the RPI-X emerging thinking many other tools will be required. These may include policy changes, a review of the Licence Obligations for all energy sector players; and a possible review of the market structure

It is broadly recognised that the RPI-X@20 basis of network regulation has proven adaptable and has served the energy sector well. We believe the existing RPI-X regime with some enhancement can better facilitate the outcomes desired - for the regulation of networks.

There are several significant variables that are contributing to a very challenging and uncertain environment for the UK Energy sector:

- The current economic climate is making it difficult to raise capital
- Govt has set tough climate change targets
- Fuel poverty is increasing.
- Project Discovery has highlighted some significant demand and supply challenges.
- Renewable technologies are evolving
- The roadmap for energy beyond 2025 is very uncertain.

Within this context we believe the role of the various participants may need to vary over the next ten to twenty years. Therefore we think it will be a combination of industry developments, coupled with appropriate regulatory change for all the sectors that will facilitate the desired energy sector outcomes. The regulatory framework will need to be evolutionary over the next decade and remain adaptable to the emerging environment. We believe the current framework can be improved but we need to recognise the points above to ensure the better facilitation of the desired outcomes.

**Question 3:** Do you think the suggested new framework is the best way of delivering these outcomes in the future? Are there any aspects you would change? Have we missed any key aspects?

The emerging thinking documents present a summary of the proposed framework and several proposals covering a vast array of ideas. It is very difficult to understand the quantum of the proposals and whether they will result in a better regulatory framework for Networks and end consumers. It will be the detailed implementation of the proposals that will dictate the impact. Until we have a complete suite of detailed proposals that we can evaluate in total, we do not think we can fully answer this question.

Given the complexity of price control reviews, and that historically, the full detail of the proposals have tended to only be made available upon release of the Final Proposals, we would welcome a mechanism by which the Networks could discuss with Ofgem, and to the extent necessary, review aspects of the Final Proposals rather resorting to the rather extreme action in a full appeal to the Competition Commission. We believe this would offer a more constructive mechanism to address any uncertainty or issues following the Final Proposals. This is particularly where Networks seek clarity on specific issues rather than re-opening the entire price control which would take up considerable time, resources and could result in additional uncertainty for Networks and their ability to raise finance in the meantime.

Within Chapter one of the consultation; “A New regulatory framework for a sustainable energy sector”, there are several references to current uncertainty and the need for the framework to be flexible. Whilst one of the desired outcomes is to have a longer term focus, we must ensure appropriate balance to allow for adaptability within any future framework.

We are generally supportive of a suggested framework for networks that is based on an ‘Ex Ante’ approach using a building block approach. We are also supportive of appropriate enhanced engagement, appropriate use of business plans, and appropriate use of outputs and appropriate incentives that stakeholders value. The key to the impact of the proposals will be how the price controls are run; and how the assessment of the building blocks would be carried out.

Most of our concern is linked to the practical implementation of many of the Embedded Financeability straw man principles. If not implemented correctly, they could introduce significant risk and uncertainty for investors and put future security of supply at risk through lack of investment. We provide a separate response to the Embedded Financeability consultation which should be read in conjunction with the responses provided here.

## Chapter 2

**Question 1:** Do you agree that a new regulatory framework should focus on delivery of desired outcomes?

We think the desired outcomes, as defined by Ofgem in Paragraph 1.7 and 1.8 fall short of those required to ensure appropriate regulation of Network Companies. Ofgem list two desired outcomes; Sustainability and Value for money for end consumers. Whatever the future regulatory framework, we think the desired outcomes should ensure:

- Efficient networks are able to finance their licence obligations;
- Networks are able to attract investment from competitive capital markets;
- An equitable sharing of risk between networks and consumers;
- Networks should not be subject to risks they cannot control;
- Networks are accountable to end consumers;
- Networks are incentivised to provide services that stakeholders value;
- Networks that demonstrate excellence are rewarded appropriately;
- Adaptability in a changing environment

We believe the new regulatory framework should focus on delivery of the outcomes we list above.

**Question 2:** Do you have any comments on the categories of outputs related to these outcomes?

The categories of Outputs listed are:

- Reliability
- Safety
- Environmental targets, particularly the delivery of low carbon energy services
- Conditions for connecting to network services
- Network related social obligations

We are supportive of these categories and would like to confirm that Security of Supply is included within Reliability. We believe the delivery of Network Services under peak winter conditions is a key output valued by the whole of the energy sector and UK Plc.

**Question 3:** Do you have any comments on how these outputs should be incorporated into the new regulatory framework?

We have a concern with regard to the incorporation of qualitative outputs and their potential impact on network revenues. There is always a certain degree of subjectivity on qualitative measures. We have highlighted that outcomes required from networks will evolve over the next decade. Some change may be required quickly and therefore some scope creep is easy to apply within a price control period. The use of qualitative outputs could result in significant risk and funding issues if the revenues associated with them are applied inappropriately. Subjective outputs may also lead to a high degree of inconsistency and confusion within a in

a sector. We would urge caution in this area of regulatory development.

The way in which outputs are incorporated into the new regulatory framework will be crucial to the success of the new framework and we look forward to working with Ofgem further on this area. We detail below some principles that should be followed:

- **Transparency and funding.** The Networks, consumers and Ofgem must have clarity on the output, the targets and funding arrangements / Revenue implications in advance of the period to which they refer. We believe some of the DPCR5 outputs are lacking in this principle.
- **Aligned to Licence conditions.** The outputs must be aligned to the obligations that a Network has and the role that networks play in the energy sector.
- **Flexibility.** During the current uncertain climate it is important that outputs reflect the requirements of the Networks. If the requirements change, then the outputs will need to adapt to reflect the future requirements
- **Consistency.** We believe it would be useful to ensure, where practicable that companies in the same sector have the same outputs. We accept that local variants may be required.
- **Reporting.** The introduction of outputs may significantly impact the reporting requirements of networks. We must ensure the introduction of an outputs based regime does not result in an overly burdensome reporting regime. This can add significant cost to networks and end consumers.

If these principles are not followed there is risk the new framework will not deliver the desired outcomes, put undue risk on networks and burden consumers with unnecessary costs.

### Chapter 3

**Question 1:** Do you agree that it is appropriate for network companies and Ofgem to improve their engagement with stakeholders as a way of improving the quality and legitimacy of decision making? Do you have any ideas on how to improve engagement by network companies and Ofgem?

We agree it is appropriate for network companies to improve their engagement with stakeholders. We believe it is appropriate to include stakeholder requirements into our business plans and to engage with consumers on an ongoing basis. There will be a cost to the increased engagement in terms of administration and reporting and we hope to work with Ofgem to develop this area further.

We agree it is appropriate for Ofgem to improve their engagement with stakeholders but Ofgem must ensure that engagement covers all relevant stakeholders. We would also like to ensure there is transparency to the networks of Ofgem engagement so that we can incorporate any additional thoughts into our business thinking.

**Question 2:** Do you think we should consider introducing a third-party merits-based right to challenge our final price control proposals?

We do not believe Ofgem should introduce a third-party merits-based right to challenge the final price control proposals. On balance, we believe there is sufficient transparency in the price control process to allow all interested parties to input into final decisions.

To further support this view, the new framework includes proposals to introduce appropriate increased use of outputs, business plans and stakeholder engagement which in our view will provide the required transparency and accountability to stakeholders.

We believe the introduction of a third party right to challenge would introduce unnecessary regulatory uncertainty and lead to possible delays to the implementation of price control decisions and therefore potentially cause delays to investment. The introduction may therefore have a negative impact on the cost of capital and cause additional unnecessary costs to end consumers.

## Chapter 4

**Question 1:** Do you have views on our suggestion that financial commitments could be provided for longer than five years for some elements of the price control? What would be the appropriate length of this partial longer period? To which aspects of the control might it be appropriate to give a longer-term commitment?

We think there are significant uncertainties highlighted within the detail of the emerging thinking that would need to be addressed before implementation of this idea could improve the regulatory framework.

Two of the desired outcomes of the regulatory review are to simplify the regulatory regime where possible and; to ensure that networks can still attract finance at appropriate cost to the end consumers. We do not believe the detailed proposals offered by Ofgem, in this area, will facilitate either of these outcomes.

EG: In paragraph 4.7 of the main consultation you state:

“The length of time over which commitment is provided for the various elements may vary by sector, **and from review to review** as network companies change”

You also state:

“The information would be also be used to assess whether rewards and penalties should be implemented”

We do not believe a “Partial” review that could vary from “review to review” with subjective rewards or penalties would deliver the desired outcomes. We believe this would add significant administrative resource and uncertainty to the regulatory process and potentially increase the cost of finance to Networks.

Under a partial review, aspects of the price control would be considered at different times. In other areas of the emerging thinking, Ofgem discuss the use of “Totex”, equalisation of



incentives and use of RORE. We struggle to understand how partial reviews would practically work alongside these other concepts.

Notwithstanding the issues we highlight, there are areas within Gas Distribution that would lend themselves to longer term negotiations.

The 30/30 Replacement programme appears to fit into this category. A longer term commitment would potentially be beneficial. It may also be more appropriate to look at the “Asset Health” of the Network infrastructure over a longer term. One could also look at the commitments on Capacity with the NTS over a longer period of time.

The length of review for these areas could be extended to periods between 5 and 10 years with suitable re-opener / adjustment mechanisms included.

**Question 2:** Do you have views on our suggestions on what business plans might look like in the new regulatory framework?

We accept the use of richer business plans could support the desired outcomes. We also agree that the business plans should be “outputs” based with regard to the requirements of stakeholders. We would also be happy to link the business plan outputs to expected costs. We would like to work with Ofgem further, to fully understand how the use of the business plan will impact the revenue determinations - when set against some of the existing building block techniques to arrive at a settlement. We are supportive of a “lighter touch” regulatory framework for networks that demonstrate efficiency and delivery of the desired outcomes. We would be supportive of a framework delivers revenues to networks based on costed business plans that meet the requirements outlined within the framework.

**Question 3:** Do you have comments on our ideas on how efficient costs might be assessed in the new regulatory framework?

Ofgem state in the consultation (para 4.18 and 4.19) they would like to be able to demonstrate “value for money over the longer term”; and then list a mix of techniques that include total cost benchmarking, “expert assessment” of network company plans, engineering models and analysis of networks’ own benchmarking. We simply need to ensure there is the appropriate level of scrutiny without an overly burdensome process and also learn lessons from previous reviews.

We are supportive of a “lighter touch” regulatory framework for networks that demonstrate efficiency and delivery of the desired outcomes.

**Question 4:** Do you have comments on our ideas on how efficient long-term delivery might be incentivised in the new regulatory framework?

Efficient networks should be funded to carry out their Licence obligations. Within the framework there should be sufficient incentive to drive network behaviour in the short, medium and long term. There should be appropriate sharing factors between networks and consumers. There will be a requirement to look at each sector differently as there are different challenges facing each sector.

The emerging thinking in this area emphasises the longer term. We would like to ensure that any change from the existing mechanisms with Gas Distribution clearly demonstrate better facilitation of the desired outcomes. The Gas distribution sector is leading the sector in relation to demand side management, we have strong environmental and social incentives and we believe the sale process, coupled with the existing incentive regime is clearly benefiting consumers. We hope these points are recognised and we look forward to further detailed work in this area.

**Question 5:** Do you have comments on our suggestions of how the new regulatory framework might encourage network companies to anticipate and deliver on the needs of existing and future consumers and network users?

There are some high level principles contained within the consultation (para 4.30 to 4.33). We recognise the challenges and broadly support the high level principles discussed. We look forward to developing the further work with you.

**Question 6:** Do you have views on our ideas on how the interactions between charging and price review incentives might be taken into account at price reviews?

Currently, we have clear and transparent Licence Obligations in relation to charging. WWU have led energy sector leading engagement with shippers to enhance cost reflectivity, transparency, predictability and stability of charges to shippers. The network sale process required Gas Networks to utilise a single entity to develop an efficient process for the sector. We are fully supportive of keeping charging under review and include charging considerations with business plan submissions. However, we must have regard to the significant potential industry costs in this area and have costs of change and the requirements of Shippers.

**Question 7:** Do you have comments on our suggestion to treat companies differently at the price control, both in terms of process and incentives, reflecting planning and delivery performance?

We are generally supportive of a regime that encourages a “lighter touch” approach to reviews for networks that have a reputation for efficient delivery. We are also generally supportive of differentiation through cost allowances and incentives. We would hope the greater focus on business plans and annual reporting regime will facilitate some reduction in administrative burden for Ofgem and networks. That said, we must ensure due regulatory process.

**Question 8:** Do you have views on our suggestion to open up some aspects of delivery to competition?

We understand the limited areas that are discussed and accept this may be appropriate for large scale projects in specific sectors – namely transmission. Within WWU we aim to be compliant with relevant procurements and carry out significant tender processes currently. Further development in this area is a matter of policy as much as regulatory review and we would be happy to engage in any future consultation in this area.

**Question 9:** Do you have comments on the design of a cross-sectoral time-limited innovation stimulus that is open to a range of parties?

In our response dated 14<sup>th</sup> September 2009 to the DPCR5 initial proposals we were supportive of the Low Carbon Network fund and suggested an extension of this fund to other sectors. We are pleased to see this recognition within the emerging thinking. We will be happy to work with you to further this theme – recognising the potential legal and regulatory hurdles we need to overcome. The literature and analysis on future sustainable options within energy is still evolving and we want to ensure we play a full part to ensure the most appropriate economic and carbon friendly solutions are developed throughout the industry to deliver the value for money solutions to end consumers. We have set up an Energy Networks Association Gas futures group and have already engaged with The Dept of Energy and Climate Change (DECC) and look forward to full engagement with Ofgem and other industry participants in the future.

**Question 10:** Do you have comments on our straw man on how we would embed our financeability duty into the new regulatory framework?

We have provided a separate, full detailed response to this parallel consultation.

## **Chapter 5**

**Question 1:** Do you agree that a new regulatory framework can deliver our desired outcomes within the existing industry structure?

It is quite clear that the current challenges facing the UK and UK energy are different to the challenges that existed twenty years ago when the RPI-X regime was introduced. The UK energy market structure, the application of the RPI-X regime, and Licence Obligations for the different participants have also evolved significantly over that time.

There are many current uncertainties in the UK and the UK energy sector. Whilst we have known legislation for our environmental challenges, there is clear uncertainty and ambiguity about how and when the UK will meet these challenges. This leads to an uncertain energy mix from 2020 to 2050. If you couple this uncertain future with the current economic climate and growing fuel poverty in the UK, it appears to suggest the need for a regulatory regime that is flexible and evolves to address the changing environment.

Due to the complex structure, it is unlikely that a review of the network regulatory regime in isolation will address all of the issues that the energy sector faces. The networks provide limited services, governed by their Licence Obligations. We agree the network regulatory regime can help; but to facilitate many of outcomes outlined by the RPI-X emerging thinking many other tools will be required. These may include policy changes, a review of the Licence Obligations for all energy sector players and a possible review of the market structure. This is an important point as we do not think the success or failure of the RPI-X@20 project should be judged by reference to delivery of the current Energy sector challenges. The RPI-X@20 review for networks should be judged against the success criteria of “Regulatory improvement for networks”. Any move away from the existing framework should demonstrate better facilitation of the desired outcomes.

**Question 2:** Do you agree that it is appropriate to encourage network companies to work with others to identify cross-sectoral solutions to the challenges the sector faces?

In principle, WWU would like to encourage more cross-sectoral solutions. The activities of participants have evolved over the last twenty years and result from Government policy and regulatory evolution. We have stated earlier in our response that an isolated review of network regulation will not in itself facilitate all the desired outcomes. Further work needs to progress carefully in this area as it is fraught with risk.

**Question 3:** Do you agree that the regulatory framework should ensure energy network companies facilitate effective competition in energy

We recognise our obligation to comply with the Gas Act section 9.1A – to run an economic and efficient gas network. We also recognise our changing obligations and have pro-actively engaged shippers to ensure better facilitation of the relevant objectives. Any further extension of network obligations should be a matter for Parliament to determine.

We support competition where it can be clearly demonstrated that competition is the most appropriate solution for end consumers – Networks should then be allowed to participate in that competitive environment.